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By Federal Express

David S. Guzy
Rules and Procedure Office
Royalty Management Program
Minerals Management Service
Denver Federal Center, Bldg. 85
P.O. Box 25165, Mail Stop 3101
Denver, CO 80225-0165

Re: Valuation of Oil From Federal and Indian Leases, 60 Fed. Reg. 65610 (December 20, 1995)

Dear Mr. Guzy:

The following comments are submitted on behalf of the California State Controller's Office (SCO) with respect to the Advanced Notice of Proposed Rulemaking (ANPR) published by the Minerals Management Service (MMS). 60 Fed. Reg. 65610 (December 20, 1995). Through that ANPR, MMS indicated its intent to reevaluate the use of posted prices for purposes of valuing crude oil produced from federal leases and requested input on potential alternatives for valuing oil sold in non-arm's length transactions.

As discussed in more detail below, SCO recommends:

1. That MMS adopt a separate rule for valuing California crude oil that looks to the prices received for Alaskan North Slope (ANS) crude oil delivered to the West Coast;

2. That MMS adopt a cap on the permissible location differential for purposes of determining value based on an ANS comparison; and

3. That MMS amend its arm's length definition to clarify that crude oil transferred under exchange or buy/sell agreements is excluded.

The Need To Reevaluate Use of Posted Prices For Royalty Purposes

SCO has long opposed use of posted prices as a means for determining the value of California crude oil production for the calculation of federal royalties. The evidence of the irrelevance of posted prices in California is overwhelming. The consistent payment of premia over postings in government auctions and arm's length transactions between companies; the significant disparity between the prices for comparable Alaskan North Slope (ANS) crude delivered into the State and crude oil produced in California; unusually high refining profits, and indeed oil industry admissions of undervaluation both before government agencies and in their internal valuations of California crude oil all attest that the use of posted prices for royalty purposes short changes the government. These facts have been confirmed by government reports, including the findings of Interior's own Interagency Task Force studying the California undervaluation problem.[1] Indeed, it could safely be concluded that the only significant remaining use of posted prices in California is for the calculation of royalties owed the lessors, including the federal government.

The historical reasons for the California undervaluation problem are in some sense unique. Yet, it is becoming increasingly clear that, nationwide, posted prices are no longer reflective of the real values in the market for crude oil. Thus, for example, information we have received demonstrates that, as far back as 1987 and continuing to the present, the posted price of West Texas Intermediate has been undervalued based on a comparison of spot and NYMEX transactions. This undervaluation has been as high as $2.00 a barrel.

SCO believes, that at least with regard to California, the royalties due as a result of undervaluation can be collected under current MMS regulations. However, it is equally clear that the current regulations place unnecessary burdens on the federal government in any effort to collect what is rightfully owed the public. This is largely, but not exclusively, due to MMS's use of posted prices as one means for valuing crude oil under its benchmark system for non-arm's length sales.

Reevaluation of the use of posted prices for determining federal royalties is long overdue. Nonetheless, SCO applauds MMS's effort to review its regulations and to consider alternatives that will not hamper the collection of the true royalty due on

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[1] The details of the undervaluation problem in California are discussed comprehensively in the comments submitted by the City of Long Beach and, thus, are not repeated here.

federal production. The road to regulatory reform, however, can be a long one. Thus, SCO urges MMS not to use its efforts to correct the flaws in its regulations as an excuse for not undertaking the collection of royalties due now because of undervaluation. In California alone, the amount past due as a result of undervaluation is as high as $850 million. This potential return eclipses any cost attributable to working through any burdens associated with the current MMS regulations.

An Alternative For Valuing Crude Oil Produced In California

Current MMS regulations establish a uniform rule for valuing crude oil produced from federal leases, applicable regardless of the location of the lease or the nature of the market for the lease production. While a nationwide rule may have appeared rational under an assumption with regard to the validity of the posted price system, adoption of a nationwide rule is unrealistic if the aim of the regulatory reform is to put in place a system for capturing the true value of production for federal royalty purposes. So long as a valuation method is certain and clear, there is little burden associated with application of variable rules.

The need for a separate rule for valuing California crude oil is clear. The West Coast market for crude oil has consistently been recognized as distinctive and separate from the markets East of the Rockies. The West Coast market is considerably more concentrated than other U.S. markets. It is dominated by seven major companies that have control over production, transportation and refining. Moreover, West Texas Intermediate is not Kern River Heavy and Cushing is a long way from Bakersfield. Currently, it does not appear that NYMEX is a substantial factor in the pricing of California crude oil. But more than geography and crude qualities distinguish the California oil market. The vast majority of crude oil in California is transferred internally or through exchanges, which reference posted prices. Outright sales of production are an exception, not a rule in California. These facts indicate that any valuation system based on tracing the specific lease production to determine the gross proceeds or the internal value to a company would be cumbersome, complicated and costly (if not futile) in the majority of situations. The rarity of outright purchase and sales contracts also means that any valuation system for non-arm's length transactions based on arm's length sales prices (posted plus premia) would be open to consistent challenges with regard to their significance and comparability. Given the likelihood of legislation establishing a statute of limitations on royalty collections and placing time limitations on the MMS audit and appeals processes, the need for an administratively simple and certain benchmark for valuing crude oil is paramount.

For oil produced in California, the price of Alaskan North Slope (ANS) oil <u>delivered</u> to the West Coast currently represents such a benchmark and SCO recommends that MMS adopt that benchmark to value crude oil produced from federal leases in the State and sold under non-arm's length contracts. There is a large and active market for ANS crude oil in California. Indeed, it currently accounts for the largest volume of oil moving in arm's length transactions in the State -- at times over

40 per cent.[2] The ANS price has been used by the federal government as a benchmark (together with the Line 63 price) for selling its production from Elk Hills in California. Companies operating in California use ANS prices as a benchmark to evaluate California posted prices. ANS prices are used by these companies in pricing California crude oil exchanged with ANS or crudes East of the Rockies. In determining the profitability of crudes to be run in their refineries, these companies also compare the profits earned on California oil against the profits earned on ANS. These actions reflect the views of the companies that, under normal circumstances, the prices of ANS and California crude oils should be set comparably. And now, with the export ban on ANS removed, there is some reason to believe that ANS prices will reflect world market values. Thus, currently ANS oil is the logical commodity to use in establishing the market value of California crude oil.

Of course certain adjustments would need to be made in order to accurately determine value. Because ANS and California crude oils are not identical, adjustments for gravity and sulfur content would be appropriate. This would be administratively simple given the gravity and sulfur banks currently in operation. The differentials used by these banks are market determined and currently reflect real economic values. However, SCO does not recommend that MMS adopt the application of the gravity and sulfur banks in a rigid rule. Rather, MMS should reserve the right of review of

[2] Thus, use of an ANS comparison would obviate the necessity of defining what is a "significant quantity" for royalty purposes.

these banks and of making adjustments that assure that such differentials reasonably reflect real economic values.

Since SCO's proposed alternative moves away from the older notions of determining value in the field and is indeed aimed at extrapolating a value given the absence of reliable data on market prices for California crude oil, MMS would not need to adjust for "transportation" in order to make the ANS comparison. Historically, the Interior Department granted allowances for transportation only when no wellhead market existed and only to the nearest available market. It was granted also to permit the Interior Department to share in greater values downstream from the wellhead. The ANS comparison is not based on an actual market transaction by a federal lessee; it is truly a value benchmark -- a substitute to account for the collapse of the posted price system.

SCO recognizes, however, that MMS in more recent years has moved away from the historical limitations on transportation allowances. SCO also recognizes that industry is less likely to willingly accept valuation alternatives for crude oil produced from federal leases, both in California and elsewhere, without some adjustment for location differences.

While SCO encourages MMS to reopen its approach to transportation allowances generally, for purposes of this ANPR, SCO would agree to consider adjusting the ANS comparison through a limited location differential. The aim of the proposed location differential would be to make the valuation comparison as if the two crudes -- ANS and California -- were being traded in the same market -- the location of delivered ANS. It is somewhat different from a transportation allowance, which permits producers to deduct from royalty their actual costs of transportation from the wellhead to their purchasers. The location differential would not be aimed at reimbursing a lessee for its particular transportation costs or otherwise subsidizing transportation.

There is limited reliable information on transportation in California upon which to compute a location differential. Because of the manner in which crude oil is currently valued in California, SCO has not had the opportunity to undertake a review of the actual transportation costs incurred by the majority of shippers. Nor does it have access to information on the formulas used by the major companies on making adjustments for location to determine the value of crude oils to their refineries. Onshore, the three major heated pipelines (capable of carrying heavy crude) are proprietary, which means that they do not publish public tariffs that might be reviewed to estimate a differential. Tariff information is available for the few "common carrier" pipelines, but the rates filed for some of these lines are clearly aberrational. This is particularly true with regard to offshore pipelines in California. On their face, the tariffs for these pipelines are exorbitant and the available financial data demonstrates an unjustifiable level of profit from their operation. It is little wonder that, for example, the 26 mile pipeline serving Point Arguello is among the ten most profitable pipelines nationwide. Oil & Gas Journal (November 27, 1995).

Moreover, the offshore pipelines service a very limited market of shippers, who are often partners in the pipeline operation. Reliance on the public tariffs of the few onshore common carriers would not provide a sample large enough upon which to estimate a reasonable location differential. While these pipelines serve a wider market of shippers, they are not subject to the same competitive forces of pipelines East of the Rockies. Little, if any, government review has been conducted on the reasonableness of these rates. Nor are these tariffs necessarily relevant to the determination of the relative value of California crude oil to the refinery markets. Determining a location differential from tariffs filed on all, or even part, of California "common carrier" pipelines would produce a result that overstates the true costs of efficient transportation at the expense of the government's royalty interest.

For these reasons, SCO recommends that MMS adopt a cap on the location differential for making an ANS comparison. SCO notes that in the Micronomics report, as submitted to the InterAgency Task Force, 50 cents was used as an estimate for the location differential in making an ANS comparison. While at this time, SCO is not recommending 50 cents as the cap, it does view that estimate as a reasonable starting point. Any cap on the location differential could be reviewed periodically to reflect any changes in the transportation costs, with the burden placed on the industry to come forward to demonstrate that the cap should be increased. Given that most pipelines in California are older and fully depreciated and the operating costs of pipelines are generally low, SCO believes that a cap would represent a reasonable measure.

SCO strongly believes that the complications of estimating a location differential in California, the nature of the pipeline systems in the State, and both the government's and industry's need for administrative certainty compels an approach that caps the differential. SCO would be willing to consider (although it does not now recommend) a supplement to a capped location differential. To supplement application of the cap, companies could calculate their actual costs of transportation used in non-arm's length (intra-corporate) arrangements.[3] This computation would serve as the basis for a location differential for such arrangements, and also could be applied to any crude oil transferred under exchange and buy/sell agreements, unless the differential negotiated in such an agreement is lower. Such a calculation would, of course, be subject to audit and MMS should specifically provide that such audit must include access to companies' internal formulae for determining value to them at the refinery gate.[4] While the result of such a calculation and subsequent audit would not permit a company to exceed the cap, it would provide MMS with the type of

[3] While SCO maintains serious concerns over MMS's current regulations governing actual cost calculations for transportation, including but not limited to the use of the Standard and Poor's BBB rating, it does not, for purposes of this ANPR, recommend particular changes to those regulations.

[4] Access to such information would serve as an important, and highly relevant, cross check on the market accuracy of any location differential since refineries will factor such a cost into their determination of the relative values to them of the crudes that they run.

information necessary to conduct objective periodic reviews of the cap. Any available tariff information, for the reasons stated above, should not be permitted to be used in lieu of making an actual cost calculation. Accordingly, SCO recommends that §206.105(b)(5) be deleted, at the very least insofar as for the calculation of the location differential for making the ANS comparison.[5]

As the collapse of the posted price system well demonstrates, there always exists a certain amount of risk in reliance on one valuation methodology. Although it is impossible to predict today, there is always the possibility of aberrational behavior in the ANS market. SCO proposes three safeguards against this.

First, SCO recommends that the historic relationship between ANS and NYMEX prices be analyzed. Thus, if ANS prices got out of line, NYMEX prices adjusted by the historic factor could be used to establish value.

Second, SCO recommends that MMS establish a floor value for production transferred non-arm's length. This floor would be the highest price at which the lessee made any outright purchase or sale of any California production in arm's length contracts. The purpose of this would be to capture as a floor value the bonus prices used in the few outright purchase and sales contracts in California. It is similar to and would supplement MMS's current rule that gross proceeds is the minimum acceptable

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[5] At some point in time, MMS may want to consider establishing a per barrel mile rate for application nationwide. Determining such a rate would be labor intensive. Since SCO believes that MMS should move forward quickly on adopting alternatives for valuation, it recommends that MMS adopt a cap, at least in the interim.

value. In order to assure that application of the recommended floor value and the gross proceeds minimum be workable, MMS should specifically clarify its right to obtain information from marketing affiliates. *Indeed, it is SCO's position that MMS* should specifically provide that nothing in its valuation regulations can serve to limit the scope of a government audit.

Third, MMS should include both an anti-circumvention and value reservation provision in its rule. An anti-circumvention provision would be aimed at protecting against marketing practices or corporate organization changes that have either the purpose or effect of avoiding application of the otherwise applicable valuation rule and resulting in a lower value. MMS would be permitted, as a result of the anti-circumvention provision to continue to value the production under the regulations as if the industry practice had not changed. A reservation provision would reserve to the Secretary the regulatory authority to value production by a method outside of the specific strictures of the rule when there is reason to believe that any benchmark set in the rule (like the collapse of the posted price system) no longer captures true values and negatively impacts the government's royalty return.

Finally, SCO recommends that MMS clarify the scope of its arm's length definition. During the proceedings leading up to the promulgation of the 1988 valuation regulations, SCO voiced strong objections to MMS's proposed definition of an arm's length contract because it was substantially narrower than traditional understandings of that term. In particular, SCO noted that MMS's definition did not address the competitive conditions in a given sales market and thus would accept as arm's length situations involving captive shippers. MMS acknowledged that its definition was narrower, but expressed its unwillingness to address what it viewed as the "subjective" issues involved in determining whether a market was "open."

SCO continues to believe that MMS's definition is overly narrow and adversely affects the government's ability to collect the true value of its royalty interest. Given the narrow scope of MMS's ANPR, however, SCO at this time recommends only that MMS clarify that its current arm's length definition excludes not only intra-corporate transfers, but also exchanges and reciprocal buy/sell agreements.

SCO believes that a correct interpretation of MMS's 1988 regulations would lead to the conclusion that crude oil transferred under exchanges and reciprocal buy/sell agreements would not be valued under the arm's length provisions of the rule, §§ 206.101, 206.102(b)(1). Among other reasons, this is due to the fact that the arm's length valuation provisions apply only to "sales" of crude oil and because the purpose of the agreements is to facilitate transportation. However, SCO is aware that some federal lessees value crude oil transferred under exchanges and buy/sells under the arm's length provisions. This suggests a need for explicit clarification of the scope of MMS's current rules.

A clarification is particularly necessary to increase the certainty of SCO's proposed alternative valuation method and should also assist MMS in meeting its royalty collection responsibilities in other areas of the country. As noted, in California a substantial portion of crude oil is transferred through exchanges and reciprocal buy/sell agreements. Although posted prices are referenced as the basis for the trade, for the companies that price term is neutral or irrelevant. As MMS has recognized "The parties can assign prices that are half the market value as long as there is reciprocal undervaluation on the crude oil sent as well as the crude oil received." Cites Service Oil And Gas Corporation, MMS-86-0538-O&G (June 12, 1987). In short, the price terms do not represent the value to the company of either the oil delivered or the oil received. Thus, clearly in order to assure the receipt of the true value of the production, a benchmark other than the price term set in exchanges and buy/sells must be applied. Adding a specific provision excluding these types of trades from the arm's length definition is the most straightforward approach for clarifying how the crude oil transferred through exchanges and buy/sell agreements should be valued.[6]

There are many other ways in which MMS's current valuation regulations could be improved to increase certainty, reduce burden and assure collection of the true value of oil for federal royalty purposes. Moreover, while SCO believes that an ANS comparison would more accurately capture the value of past and currently produced crude oil, as the discussion above suggests, it maintains some degree of concern over the use of that methodology indefinitely. Unfortunately, MMS does not currently

[6] To assist in the collection of the true value of royalties now due, SCO also urges MMS to issue a formal policy interpretation on the treatment of buy/sell arrangements under its current regulations that reflects the discussion above.

compile the type of information necessary to make a more considered review of how market prices are determined. Undertaking at this time a wider scale review and revision of MMS's regulations is not feasible. While collection of the true value under MMS's current regulations remains possible, it is in the government's interest to move quickly to abandon regulatory provisions that hamper or impede its ability to perform its statutory mandates. Change is needed immediately. Thus, SCO recommends that its alternative methodology be adopted now as an interim rule but that MMS continue to go forward, through more comprehensive audits and objective studies, to compile the information needed to formulate an approach to valuation that is better able to reflect the market and to respond to market changes. Acceptance by MMS of SCO's alternative valuation methodology, as an interim rule, would go a long way towards protecting the revenue interests of both the federal government and California. SCO stands ready to answer any further questions MMS may have concerning its proposal and to work with MMS in this endeavor.

Respectfully submitted,

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on behalf of the California
State Controller's Office